

**Letter of Findings: 02-20130359**  
**Corporate Income Tax**  
**For the Years 2009, 2010, and 2011**

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

**ISSUES**

**I. Corporate Income Tax - Cost-of-Performance.**

**Authority:** IC § 6-3-2-1(b); IC § 6-3-2-2; IC § 6-3-2-2(a); IC § 6-3-2-2(b); IC § 6-3-2-2(e); IC § 6-3-2-2(e)(2)(B); IC § 6-3-2-2(f); IC § 6-3-2-2(f)(1); IC § 6-3-2-2(f)(2); IC § 6-3-2-2(h)-(k); IC § 6-3-2-2.2; IC § 6-8.1-3-21; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); [45 IAC 3.1-1-38](#); [45 IAC 3.1-1-55](#); Letter of Findings 02-20130238 (July 29, 2013); Letter of Findings 02-20120316 (September 7, 2012); Letter of Findings 02-20090496 (October 26, 2009); Letter of Findings 02-20040005 (June 19, 2006); Letter of Findings 02-20020518 (June 13, 2006); Letter of Findings 02-20030154 (October, 21, 2004); Letter of Findings 02-20020060 (August 7, 2003); Federal Accounting Standards Advisory Board, FASAB Handbook (11<sup>th</sup> ed. 2012), available at [www.fasab.gov/pdffiles/2012\\_fasab\\_handbook.pdf](http://www.fasab.gov/pdffiles/2012_fasab_handbook.pdf); P.L. 145-2007, § 17; MTC Reg. IV.17.(4)(B)(c); Black's Law Dictionary (9th ed. 2009).

Taxpayer argues that, for purposes of calculating its Indiana adjusted gross income, it is entitled to source income received from Taxpayer's Indiana "online" students on a "cost of performance" basis and that the Department's position to the contrary is mistaken.

**II. Corporate Income Tax - Underpayment Penalty.**

**Authority:** IC § 6-3-4-4.1(d); IC § 6-8.1-10-2.1(b); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2\(c\)](#).

Taxpayer maintains that the Department should exercise its discretion to abate a ten-percent "underpayment" penalty.

**STATEMENT OF FACTS**

Taxpayer is an out-of-state business which provides private educational services through wholly owned subsidiaries. Taxpayer provides its services by means of its Internet "online learning system" and also at various campus locations including locations found in Indiana. The programs at the local campuses are identical to programs offered to the online students; educational information provided to Indiana students in its online courses is identical to that provided to those students who attend classes at one of Taxpayer's Indiana campus locations. While Taxpayer - serving customers nationwide - does not generally "tailor" its curricula for Indiana students, Taxpayer offers both its online students and its local campus students education courses necessary to obtain Indiana teacher licensure.

Although the Indiana online students may not attend local campus courses nor consult with local campus faculty members, the online students have access to and may use the educational facilities at the Indiana local campuses and may interact with Taxpayer's "Graduation Team" members located on those campuses.

The online students are supervised by "instructors located throughout the United States." Although a "significant number" of the online instructors are located in Taxpayer's home state, "the majority of [the] faculty is found elsewhere throughout the United States."

Taxpayer receives two distinctive streams of income: (1) Taxpayer receives income from the Indiana students who attend classes at Taxpayer's Indiana campus locations; and (2) Taxpayer receives income from the Indiana students who participate in Taxpayer's online course offerings.

The Department of Revenue ("Department") conducted an audit of Taxpayer's income tax returns and financial

records. Taxpayer sourced to Indiana only the money received from Indiana students receiving educational services at one of Taxpayer's Indiana campuses. The audit assessed additional income tax on the ground that Taxpayer should have also included income received from Indiana online students in the numerator of Taxpayer's sales factor.

Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

## **I. Corporate Income Tax - Cost-of-Performance.**

### **DISCUSSION**

The issue is whether the money Taxpayer receives from its online, Internet students should be included in the numerator of the sales factor on the ground that the money is obtained from conducting "business in this state." Taxpayer asserts this money should not be included in the numerator of the sales factor based on the Cost-of-Performance ("COP") apportionment methodology. In support of this argument, Taxpayer points to its "cost-of-performance study" which consists of multiple spreadsheets which summarize computer data statistics.

#### **A. Introduction - Sourcing Income of a Multi-State Corporation Doing Business in Indiana for Purposes of Indiana's Corporate Income Tax.**

In apportioning a taxpayer's income between states during 2009 and 2010, Indiana retained a version of the three-factor payroll, property, sales apportionment method. In 2011, Indiana adopted a single sales factor formula to determine the apportionment amounts. IC § 6-3-2-2. The sales factor consists of the taxpayer's Indiana sales (the numerator) over the taxpayer's "everywhere" sales (the denominator). IC § 6-3-2-2(e).

In calculating a business's corporate income tax liability, the first step is to identify the taxpayer. If the taxpayer is a corporation, income tax is imposed on income derived from sources in Indiana. IC § 6-3-2-1(b). The second step is to identify the Indiana income. IC § 6-3-2-2(a) defines income derived from sources within Indiana. If it is not "business income," then the special rules for allocating the income apply under IC § 6-3-2-2(h)-(k); if it is "business income," then the apportionment rules under IC § 6-3-2-2(b) are in effect.

The third step requires a determination whether the sales occur in Indiana. Was the subject of the sale real property, tangible personal property, or intangible personal property? The sale of real property is sourced to where the real property is located. If the real property is located in Indiana, then the income is included in the sales numerator under IC § 6-3-2-2(e). If the income is derived from the sale of tangible personal property, then the income is sourced to where the tangible personal property was delivered. *Id.* If the tangible personal property is delivered outside Indiana but the income is not subject to tax in the destination state, then the receipts are "thrown back" to Indiana under IC § 6-3-2-2(e)(2)(B). If the income is attributable to the discrete category of intangible personal property specifically identified in IC § 6-3-2-2.2, the income is apportioned under the special rule found in that statute.

All other intangible personal property income - including income from providing services - is addressed in IC § 6-3-2-2(f) and requires an identification of the "income producing activity" ("IPA") as defined under [45 IAC 3.1-1-55](#). ("[A]ct or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit.") If the IPA is the principal source of the taxpayer's source of business income, the income is apportioned to Indiana to the extent that the IPA occurs in Indiana under IC § 6-3-2-2(f)(1). If the IPA is not the principal source of the taxpayer's business income, the income is sourced to the location where IPA occurred under [45 IAC 3.1-1-55](#). If a greater proportion of the services are provided in Indiana than are provided elsewhere, the taxpayer must identify the direct costs of performance to define that proportion of the IPA performed in Indiana as provided under [45 IAC 3.1-1-55](#). If a greater proportion of the IPA is performed in Indiana, the income is included in the Indiana sales numerator. If a greater proportion of the IPA is performed outside Indiana, the income is allocated elsewhere and is not included in the sales numerator but is included in the denominator of the apportionment calculation.

#### **B. Sourcing Indiana Business Income From Intangibles and "Cost of Performance."**

IC § 6-3-2-2(a) states in relevant part:

With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

- (1) income from real or tangible personal property located in this state;
- (2) income from doing business in this state;
- (3) income from a trade or profession conducted in this state;
- (4) compensation for labor or services rendered within this state; and
- (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. (Emphasis added).

[45 IAC 3.1-1-38](#) defines "doing business in the state":

Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

- (1) Maintenance of an office or other place of business in the state
- (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
- (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
- (4) Rendering services to customers in the state
- (5) Ownership, rental or operation of a business or of property (real or personal) in the state
- (6) Acceptance of orders in the state
- (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [[45 IAC 3.1-1-37](#)], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of [IC 6-3-2-2\(b\)-\(n\)](#). (Emphasis added).

In determining which of Taxpayer's sales are located in this state, the purpose of the apportionment formula's sales factor is to represent the market where a taxpayer's products or services are sold. When the Department attempts to tax the adjusted gross income associated with the sale of goods, it is relatively easy to identify the market where goods are ultimately sold. See IC § 6-3-2-2(e) (explaining that sales of tangible personal property are in this state if the property is delivered or shipped to a purchaser, other than the United States government, within this state, regardless of the f.o.b. point or other conditions of the sale). However, determining the market for the sale of services or other intangibles that do not fall under IC § 6-3-2-2.2 is more complex. To this end, cost of performance ("COP") is an apportionment tool intended to identify the market for services or other intangibles - other than those found under IC § 6-3-2-2.2 - when the taxpayer's income is not attributable to that taxpayer's principal business or, alternatively, when the market for the services can be identified but the locations of the costs associated with services can be identified. In this particular instance, the audit concluded that tuition received from Indiana students receiving online, Internet instruction constituted a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from where Taxpayer received income.

The Department's audit found that "Taxpayer included only the tuition income received from students attending classes on the . . . Indiana campuses in the numerator of the sales factor."

As noted in the audit report:

Taxpayer excluded all 100[percent] of the on-line lecture tuition income from Indiana customers in Indiana receipts numerator factor while included in everywhere receipts received in denominator based on "Cost of Performance" Rule. (Emphasis added).

According to the audit report, Taxpayer's "cost-of-performance" stance was based on IC § 6-3-3-2(f) which states:

Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:

- (1) the income-producing activity is performed in this state; or
- (2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance. (Emphasis added).

The audit concluded that tuition received from Indiana students receiving online, Internet instruction constituted a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from

where Taxpayer received income. Further, the audit report pointed out that [45 IAC 3.1-1-55](#) is the rule for determining if "income-producing activity" is performed in Indiana and if the money earned from that activity is included in the numerator of the sales factor. Under that provision, the general rule is that "the income-producing activity" is "deemed performed" and is attributed to "the situs of the real, tangible, and intangible property" or to the place "where personal services are rendered." However, the term "income producing activity" ("IPA") is defined as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit." *Id.*

The audit report noted that Taxpayer disagreed on the COP issue. The report stated that "[T]axpayer and the Department could not reach an agreement regarding the proposed audit adjustment." In an audit which commenced March 2012 and concluded August 2013, the COP issue was discussed with Taxpayer as early as September 2012 and as late as February 2013. However, the audit report eventually concluded that there was no need to apply the COP methodology because the Department was merely apportioning Taxpayer's principal source of income generated from the sale of services to Indiana residents.

In considering Taxpayer's various arguments and as a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." See *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer disagrees with the conclusion reached in the Department's audit report that money received from Indiana online students should be included in the numerator of the sales factor. According to Taxpayer:

During the Periods at Issue, the majority of Taxpayer's income producing activities costs related to its Online Campus were incurred outside Indiana. As a result, all of Taxpayer's receipts derived from its Online Campus are properly excluded from the Indiana sales factor numerator. Taxpayer performed the majority of its Online Campus activities outside Indiana as exemplified by the location of Taxpayer's Online Campus personnel, eCampus platform, servers, and curricula development.

Taxpayer argues that "any attempt by the Department to assert a 'pro-rata' cost of performance rule is invalid" and any attempt to do so is "invalid" on the ground that [45 IAC 3.1-1-55](#) is "inconsistent with the statute it is administering . . . [and] is invalid and therefore unenforceable." However, the audit report is clear that service income received from Indiana students performing online class work "is sourced to the place where the 'personal services are rendered.'" In this particular case, it was the audit's position that the service income is sourced to Indiana because that is the place where Taxpayer's services - its principal source of business income - are "rendered" to its Indiana customers.

### **C. Application of the Cost of Performance Method Based on the Taxpayer's Administrative Protest**

Typically, the Department does not reach the COP issue under IC § 6-3-2-2(f)(1) because the Department only seeks to include in the numerator money earned from the income-producing activity performed in Indiana and does not seek to include income-producing activity performed both within and without Indiana under IC § 6-3-2-2(f)(2). Because taxpayers only pay adjusted gross income taxes on the IPA conducted in the state, the COP associated with in-state IPA is typically not relevant. ("Income Producing Activity" is defined at [45 IAC 3.1-1-55](#)). Nevertheless, Taxpayer asserted during the audit, and again during the administrative protest, that the COP apportionment methodology should be applied to the income generated from its Indiana customers that received educational services online rather from the Taxpayer's Indiana campus.

The Department's regulation, [45 IAC 3.1-1-55](#), interprets IC § 6-3-2-2(f). The regulation states in relevant part:

When Sales Other Than Sales of Tangible Personal Property Are in This State. Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity which gave rise to the receipts is performed wholly within this state. **Except as provided below** if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity ["IPA"] is performed here, based on costs of performance.

The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of

the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, "income producing activity" includes but is not limited to the following:

- (1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.
- (2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property.
- (3) The sale, licensing the use of or other use of intangible personal property.

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

If receipts from sales other than sales of tangible personal property do not constitute a principal source of business income and such receipts are included in the denominator of the receipts factor, such receipts are in this state if:

- (a) the income producing activity is performed wholly within this state; or
- (b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

... Except as provided by special apportionment formulas, receipts from sales other than sales of tangible personal property which constitute a principal source of business income shall be attributed to this state in accordance with the following:

- (a) Gross receipts from the sale, lease, rental or other use of real property are in this state if the real property is located in this state.
- (b) Gross receipts from the rental, lease, licensing the use of or other use of tangible personal property shall be assigned to this state if the property is within this state during the entire period of rental, lease, license or other use. If the property is within and without this state during such period, gross receipts attributable to this state shall be based upon the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.
- (c) Income from transportation between a point in Indiana and a point outside Indiana shall be attributed to this state on a mileage basis. See Regulation 6-3-2-2(l)(020) [[45 IAC 3.1-1-63](#)].
- (d) Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. If the services are performed partly within and without this state, such receipts shall be attributed to this state based upon the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.

(Examples omitted).

When an Indiana taxpayer is entitled to apply the COP methodology to its sales, the first step is defining the IPA and the second step is determining where the IPA in question occurred. As explained above, Indiana defines IPA as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit." [45 IAC 3.1-1-55](#). Based on the Indiana regulation definition cited, it is apparent that Indiana has adopted a transactional-based approach when applying the COP apportionment methodology. [45 IAC 3.1-1-55](#) plainly states that "[g]ross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income producing activity which gave rise to the receipts is performed wholly within this state." Such an approach to the income-producing activity requires consideration of each individual transaction from which the taxpayer receives payment from a customer.

Under the transactional approach, the analysis begins with identifying the transactions that constitute the IPAs or include the IPAs. Although defining the IPA may differ from one industry or business to another, there are several factors common to each. These factors include considering only the direct activity for which value is exchanged (i.e. the transfer of the goods or services). In some industries, simply providing access to the State's residents is the IPA, rather than the activity that is conducted to provide the actual service. Typically, administrative and executive activities are excluded from defining the IPA, because defining the IPA is a question of identifying individual transactions. Similar to Indiana's definition of IPA, the Multistate Tax Commission ("MTC") has explained that IPA generally means "the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income." See P.L. 145-2007, § 17; also IC § 6-8.1-3-21 (2009) (explaining that Indiana rejoined the MTC as an associate member effective July



1, 2007; also MTC Reg. IV. 17.(2)). The MTC regulations further provide that "[t]he term 'IPA' applies to each separate item of income." Id. The MTC's regulation continues, providing specific guidance regarding the application of the COP methodology. "[W]here in the case of personal services are performed partly within and partly without this state, the services performed in each state shall constitute a separate income producing activity . . ." MTC Reg. IV.17.(4)(B)(c) (Emphasis added). Thus, the MTC has explained that if the IPA occurs in multiple states, the IPA must be divided amongst the states and each state having the right to treat the IPA occurring within its borders as a separate, taxable transaction.

The next step is to identify the gross receipts derived from those transactions. This step is directly connected to the first step of Indiana's transactional-based approach. Once the IPA is identified, a review of the taxpayer's documentation is necessary to identify the receipts directly linked to the IPAs. In other words, the final step is to determine the direct costs (i.e. COP) associated with the IPA and the geographic location of the particular COP. According to Indiana's regulation, cost-of-performance "means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer." [45 IAC 3.1-1-55](#) (Emphasis added). According to the "Federal Accounting Standards Advisory Board" ("FASAB") Handbook, a "Direct Cost" is defined as "[t]he cost of resources directly consumed by an activity. Direct Costs are assigned to activities by directly tracing of units of resources consumed by individual activities. A cost that is specifically identified with a single cost object." Federal Accounting Standards Advisory Board, FASAB Handbook, Version 11, Appendix E - Page 23 (11<sup>th</sup> ed. 2012) (available at [www.fasab.gov/pdffiles/2012\\_fasab\\_handbook.com](http://www.fasab.gov/pdffiles/2012_fasab_handbook.com)). Furthermore, a "Cost Object" is defined as "[a]n activity, output, or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a function, task, product, service, or a customer." FASAB Handbook, Version 11, Appendix E - Page 19. Additionally, Black's Law Dictionary defines a direct cost as "[t]he amount of money for material, labor, and overhead to produce a product." Black's Law Dictionary 398 (9th ed. 2009). In summary, direct costs are those costs that are only incurred because the revenue producing transaction or activity in question occurred. Alternatively, indirect costs are those that would be incurred by a taxpayer even if the IPA transaction in question had not occurred.

In this case, the Department is taxing only the IPA activities that occurred in Indiana. Therefore, applying the COP methodology is entirely inappropriate. However, even if the COP method were applied to Taxpayer's sales in question, the result would be the same—income from Indiana residents would still be subject to tax.

Taxpayer's services took place here in Indiana because Indiana is the location where the students purchased Taxpayer's services and participated in Taxpayer's classes regardless of whether those services were received at one of Taxpayer's campuses or whether the services were delivered online to one of its Indiana students. Thus, Taxpayer's IPAs consist of the individual transactions that it engaged in with Indiana residents when the residents purchased educational services from Taxpayer. Selling educational services to Indiana students were the acts directly engaged in by Taxpayer for the purpose of obtaining gains or profit. Further, these activities were engaged in by Taxpayer in the regular course of its trade or business. It was these individual transactions for which value was exchanged between the Indiana residents and Taxpayer. The amount of income Taxpayer earned from selling its educational services to Indiana residents is readily available from Taxpayer's records and is not an issue for purposes of this analysis.

Thus, the Department agrees with the audit's analysis and concludes that the actual "income producing activity" is performed in Indiana because "the acts or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit" occur in Indiana. [45 IAC 3.1-1-55](#). Taxpayer does not earn money from developing class curricula at an out-of-state location, because it incurs "corporate support" expenses outside Indiana, or because Taxpayer maintains computer servers outside this state; further Taxpayer does not earn money because its Indiana online students pay Taxpayer to incur expenses outside Indiana or conduct out-of-state research on those students' behalf. Taxpayer earns money because it prepares online educational services and then sells those services to Indiana customers within their home state. The money earned from those Indiana sales transactions constitutes Indiana source income.

In summary, receipts from any "income producing activity" performed in Indiana are always attributed to Indiana under IC § 6-3-2-2(f)(1); all of the receipts or a principal source of business income are attributed to Indiana when, under the cost of performance rules, the greater proportion of the income producing activity is performed in Indiana under IC § 6-3-2-2(f)(2) and [45 IAC 3.1-1-55](#).

Taxpayer suggests that the income it earns from Indiana students does not relate to Indiana; Taxpayer transforms the income from its sale of services to Indiana students into income earned from an out-of-state activity under what the Department has previously determined is an erroneous and unsubstantiated application of a COP

analysis. Formulary apportionment is designed to align the income tax multistate taxpayers - such as Taxpayer - report to the states in which they conduct business with that taxpayer's business activity conducted in those states. Formulary apportionment is not designed to create income untaxed by any state or to exclude money earned from Indiana business activity from the Indiana sales numerator.

The Department has previously, consistently, and long held that "cost of performance" rule on which Taxpayer relies applies in two specific narrow situations: (1) when attributing all of the receipts for a principal source of business income to Indiana because the greater proportion is performed in Indiana; (2) when income is not a "principal source of business income" and the greater proportion of the income producing activity is performed outside of Indiana. While Taxpayer has service income derived from intangible property, the income is a "principal source of business income" for Taxpayer and is from "income-producing activity" that was performed in Indiana under [45 IAC 3.1-1-55](#). Letter of Findings 02-20130238 (July 29, 2013) 20130925 Ind. Reg. 045130426NRA; ("Taxpayer does not earn money because a specific Indiana customer hires Taxpayer to conduct out-of-state financial research on that particular customer's behalf; Taxpayer earns money because it conducts financial research and then sells the results of that research to Indiana customers. The money earned from those Indiana sales transactions constitutes Indiana source income."). See also Letter of Findings 02-20130238 (July 29, 2013); 20140129 Ind. Reg. 5140003NRA; Letter of Findings 02-20120316 (September 7, 2012), 20121128 Ind. Reg. 045120595NRA; Letter of Findings 02-20090496 (October 26, 2009) 20091223 Ind. Reg. 045090944NRA; Letter of Findings 02-20040005 (June 19, 2006), 20060823 Ind. Reg. 045060298NRA; Letter of Findings 02-20030154 (October, 21, 2004), 28 Ind. Reg. 1399; Letter of Findings 02-20020060 (August 7, 2003), 27 Ind. Reg. 698.

Nonetheless, Taxpayer asks the Department to accept its conclusion predicated on its bare assertion that "Taxpayer's Online Campus Services are 'rendered' outside Indiana" because "[t]he location of Taxpayer's Online Campus personnel, eCampus platform, curricula development, online servers, and marketing activities are all located outside the state of Indiana." Although Taxpayer has provided a "Cost of Performance Report Summary" for the years at issue, the documents are just as Taxpayer represents; the documents are essentially a summary of Taxpayer's costs and expenses. Taxpayer's premise is that the activities that produce the earnings obtained from its Indiana on-line students are attributable to multiple out-of-state locations. Even accepting that premise, the calculation of those activities and costs across several states is undeniably complex and whether Taxpayer's "Summary" correctly or arbitrarily represents those costs and activities is a matter outside the scope of this Letter of Findings. As noted at the outset, IC § 6-8.1-5-1(c) requires that Taxpayer demonstrate that the original audit's finding and consequent assessment is "wrong." Bearing that standard in mind, it may well be that a reliable and independent calculation of Taxpayer's costs, expenses, and activities would produce a far different result than that offered by Taxpayer. That said, it is not possible to sustain Taxpayer's objection based on the conclusory documentation provided.

The audit correctly found that the income Taxpayer received from Indiana students receiving online, Internet instruction constitutes a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from where Taxpayer receives income.

## FINDING

Taxpayer's protest is respectfully denied.

## II. Corporate Income Tax - Underpayment Penalty.

### DISCUSSION

Taxpayer objects to the imposition of the ten percent "underpayment penalty." The penalty is authorized under IC § 6-3-4-4.1(d);

(d) The penalty prescribed by [IC 6-8.1-10-2.1](#)(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

(1) the annualized income installment calculated under subsection (c); or

(2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25[percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

IC § 6-8.1-10-2.1(b) sets the amount of penalty as ten percent. However, IC § 6-8.1-10-2.1(d) provides:

If a person subject to the penalty imposed under this section show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

Departmental regulation [45 IAC 15-11-2](#)(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

In particular, Taxpayer argues that it "properly calculated its Indiana sales factor by sourcing its service revenue based on costs of performance" and that "[t]his is the methodology Indiana's legislature dictated to source Taxpayer's service-based receipts."

As discussed in Part I above, the Department disagrees with Taxpayer's substantive argument. However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and prudence . . . ." and that the penalty should be abated.

### **FINDING**

Taxpayer's protest is sustained.

### **SUMMARY**

The Department agrees that the "underpayment penalty" should be abated; in all other respects, Taxpayer's protest is denied.

*Posted: 11/26/2014 by Legislative Services Agency*  
An [html](#) version of this document.